The Ukrainian Stock Market

Higher corporate governance standards could ease the liquidity problem of the stock exchange

Valentin Zelenyuk

The origins of the Ukrainian equity market date back to the privatization process in the early 1990s. The market stayed fairly underdeveloped for about a decade. It almost collapsed during the 1998 financial crisis, barely recovered after that and stagnated for another few years. However, it suddenly exploded in 2004, bringing more than 1000% to date. In July 2007, the Ukrainian stock market was ranked the best performing stock market in the world.

Most Ukrainians would be surprised to learn that there is more than one stock exchange in the country — there are actually a dozen licensed by the State Securities Exchange Commission, of which seven are located in Kyiv, and the rest are in the regions. The most dynamic of these is the First Securities Trading System (PFTS), which was founded in 1996 as an electronic over-the-counter (OTC) trading platform and then upgraded into a securities exchange in 2006. It now covers about 95% of the total trading volume of organized stock exchanges in Ukraine.

The Ukrainian stock market grew 1000% from 2004 to date

The Ukrainian equity market is often thought of as an emerging market, but in fact, by Standard & Poor's official classification, it is still a so-called "frontier market", which discourages many large pension and hedge funds from investing in it. On the other hand, when this status is upgraded, one can expect a large inflow of portfolio investments into Ukraine.

The Largest Frontier Market

Currently, Ukraine's stock market capitalization is about US$77 billion, making it the largest of Europe's frontier markets and even larger than some emerging markets, e.g. Hungary's. Yet it is almost four times smaller than that in Poland. It is also second biggest by market capitalization as a percentage of GDP, after Croatia, and similar to Poland. To Ukraine's advantage is the fact that a substantial number of the traded companies are fairly large by international standards, something that many Eastern European countries lack. However, Ukraine's GDP is still fairly low. So, when measured by market capitalization per capita, Ukraine falls back to the second lowest place (US$1,650), only ahead of Bulgaria (US$529) and far behind Hungary and Poland (US$4,900 and US$7,600, respectively). Nevertheless, this suggests a great growth potential, especially when more Ukrainian companies go public and ordinary citizens start investing in the stock market.

Besides, the Ukrainian equity market is fairly diversified — especially in comparison to neighboring Russia. Indeed, while the majority of stocks are related to the iron and steel industry (the main export of Ukraine) it is by no means a dominant sector on the PFTS (about 22%), with other sectors, such as banking (17%), power utilities (14%), oil and gas (11%), telecommunications (9%), pipes (6%), and engineering (5%) gradually expanding their presence.

Low Liquidity and Poor Corporate Governance

Until recently, the market was characterized by poor corporate governance, with numerous examples of asset stripping and stock diluting. But things are changing rapidly and many companies are improving corporate governance and becoming more transparent. There have even been voluntary reversals of previous decisions, such as cancellations of earlier stock diluting. Most of these steps have been based on pragmatic considerations, as some companies are now striving to improve their image before going for IPOs on major international stock exchanges. Improvements in corporate governance practices were greatly appreciated by portfolio investors, and this pushed prices up sometimes by as much as 1000% since the beginning of 2007.

Low liquidity remains one of the main problems of the Ukrainian stock market, with an average volume on the PFTS amounting to only about US$5.5 million per day in the first half of 2007. A small free float is another problem, which is also one of the reasons for the low liquidity. Even for some blue chips the free float does not exceed 2%.

Lucrative Opportunities

There still exist several thousand companies where the state has a stake. Sooner or later, these will come to the market. Among the most lucrative state-owned assets is Ukrtelecom — the state monopoly in fixed-line telecommunication, whose market capitalization is estimated at about US$4 billion.

About 60 Ukrainian equities can be purchased through ADR or GDRs, while about a dozen Ukrainian companies went further and carried out IPOs on international stock exchanges — most of them on AIM, the London Stock Exchange's market for smaller growing companies. Other companies have voiced similar plans, and 2008-2010 can become an era of massive Ukrainian IPOs abroad.

IPOs at major international stock exchanges require substantially higher standards of transparency which are hardly reachable for most Ukrainian companies at this point. This is one of the key reasons why most Ukrainian companies go for local listing — and this has helped the development of the local market. As Ukrainian companies get gradually accustomed to internationally accepted governance standards and go public internationally, the local stock market should also aspire to improve domestic standards in order to avoid becoming a market for junk stocks. Higher corporate governance standards, and increased transparency in particular, could also ease the liquidity problem on the Ukrainian stock exchange — by attracting more buyers to the market.

Valentin Zelenyuk is a Chief Economist-Strategist of Millennium Capital and is a visiting professor of Kyiv Economics Institute and Kyiv School of Economics (EERC). The views expressed in this article are those of the author and do not represent the official views of the abovementioned organizations. **BT**